

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of	)	
	)	DOCKET NO. 15565
[Redacted]	)	
	)	DECISION
Petitioners.	)	
_____	)	

On February 12, 2001, the Idaho State Tax Commission (Tax Commission) issued a Notice of Deficiency Determination to [Redacted] (petitioners) for taxable years 1996, 1997, and 1998. The Notice of Deficiency Determination did not result in any additional amount due or refund owed. However, the Notice of Deficiency Determination does substantially reduce the amount of Idaho net operating loss available as a carryforward to future taxable years. The petitioners filed a timely protest and petition for redetermination. The Tax Commission, having reviewed the file, hereby issues its decision.

In General

The petitioners are husband and wife and were apparently Utah residents. The husband owns an interest in numerous partnerships, limited liability companies (hereafter “LLC”), and S corporations, some of which are transacting business within Idaho. Many of the partnerships, S corporations and LLC’s that the husband owns an interest in are also partners or members of numerous other partnerships and LLC’s, thus creating an extremely complex structure of tiered flow-through entities.

The Tax Commission’s Income Tax Audit Bureau (hereafter “ITA”) audited a number of the entities that the husband was an owner in and made several adjustments that impacted the amount of Idaho source income reportable by the petitioners to Idaho. Only one of the entities that the petitioners own an interest in protested the adjustments made by ITA.

The adjustments made to the various entities as well as the treatment of investment interest expense under Idaho law has a material impact on the calculation of the Idaho net operating loss. The majority of the impact to the petitioners' Idaho net operating loss carryforward was the result of audit adjustments made to one particular S corporation (hereafter "S Corp. X"). S Corp. X filed a petition for redetermination. The Tax Commission has issued a decision in that case. See Tax Commission Decision docket number [Redacted].

ITA, beginning with taxable year 1983 and after taking into consideration the various adjustments to the flow-through entities that the petitioners owned an interest in, redetermined the amount of Idaho net operating loss available as a carryover to taxable year 1999. Under ITA's calculation, the amount of Idaho net operating loss available as a carryover to taxable year 1999 is \$1,752,481.<sup>1</sup>

In the petitioners' petition for redetermination, the petitioners object to the reduction of their Idaho net operating loss carryover from \$6,934,573 to \$1,752,481, a reduction of \$5,182,092. However, according to a schedule prepared by the petitioners' representative, the Idaho net operating loss carryover into 1999 is only \$6,039,231.<sup>2</sup> The difference between \$6,934,573 and \$6,039,231 is \$895,342. The \$895,342 difference represents the amount of Idaho net operating loss carryover from taxable years 1987 and 1988 that has expired as a result of the statute of limitations found in Idaho Code section 63-3022. Thus, the difference between ITA's calculation and that of the petitioners is \$4,286,750.

In the petitioners' petition for redetermination dated April 12, 2001, the petitioners state:

It seems inconsistent to treat the interest income as business income and the interest expense as a non-business deduction simply because it flows through as investment interest on the shareholder's Schedule A, due to the passive loss rules created by the 1986 Tax Reform. If Idaho is going to treat the interest expense as

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<sup>1</sup> ITA's calculation is shown in Exhibit 1, which can be found at the end of this decision.

<sup>2</sup> The petitioners' calculation is shown in Exhibit 2, which can be found at the end of this decision.

investment expense then it should at least follow the federal treatment of allowing the interest expense as a deduction for NOL purposes to the extent of investment income and as a separate investment expense carryover to the extent it exceeds the investment income.

NOL. Idaho Code 63-3026A defines the term “Idaho source income” to include income attributable to “any business, trade, profession or occupation conducted or carried on in this state, including . . . the pro rata share of S corporation income and **deductions**.” Idaho code 63-3026A(3)(a). In addition, Idaho Income Tax Administrative Rule 263 specifically provides that:

The taxable amount of a shareholder’s pro rata share. . . of business income, gains, losses, and other pass-through items from an S corporation. . . . operating both within and without Idaho is determined by multiplying each pass-through item by the Idaho apportionment factor of the business.

We do not believe that the interest income should be treated as business income contrary to federal treatment and then inconsistently use the Federal rules for treatment of the directly related interest expense as investment expense simply to advantage Idaho over another state. That surely cannot be the intent of Idaho Tax Law.

Unfortunate for the petitioners, the remedy they seek is simply not supported by Idaho law.

### **Law and Analysis**

#### **Calculation of a Nonresident’s Idaho Taxable Income**

The petitioners’ primary objection is the treatment in taxable years 1987 through 1998 of interest income flowing from S Corp. X to the petitioners as Idaho source income while at the same time treating the interest expense incurred by S Corp. X, and passed through to the petitioners, as an itemized deduction which is excluded from the calculation of the petitioners’ Idaho net operating loss in tax years 1989 through 1998. The Tax Commission’s decision in docket number 15562 discussed the treatment of the interest income as business income subject to apportionment. The focus of this decision will be the inclusion of a nonresident’s Idaho source income in their calculation of Idaho taxable income as well as the treatment of investment

interest expense for purposes of calculating a nonresident's Idaho taxable income and Idaho net operating loss.

Idaho Source Income from an Ownership in an S Corporation Transacting Business in Idaho  
or Having Business Situs Within Idaho

From 1996 through 1999, Idaho Code section 63-3026A and the rules thereunder governed the calculation of a nonresident's Idaho taxable income. For years 1983 through 1995, Idaho Code section 63-3027A and the rules or regulations thereunder govern the calculation of Idaho taxable income.

From 1983 through 1998, the inclusion of a nonresident's Idaho source income in the calculation of Idaho taxable income was set forth in either Idaho Code section 63-3026A or 63-3027A and the rules or regulations thereunder. For taxable years 1996 through 1998, Idaho source income includes "any business, trade, profession or occupation conducted or carried on in this state, including the . . . prorata share of S corporation income and deductions." Idaho Code section 63-3026A(3). For tax years prior to 1996, Idaho source income included the distributive shares of income from any small business corporation having business situs within Idaho. See Idaho Income Tax Regulation 27A.c. (1983 thru 1992) and Idaho Administrative Rule 80.03 (1993 thru 1995). To the extent that the petitioners were required to report Idaho source income from their ownership interest in S Corp. X, ITA was correct in including the petitioners' Idaho source income in the calculation of Idaho taxable income.

Itemized Deductions Included in a Nonresident's Idaho Taxable Income

Included in the calculation of Idaho taxable income under Idaho Code sections 63-3026A (1996 through 1998) and 63-3027A (1983 through 1995) was the allowance of a deduction for what is commonly referred to as "a standard deduction or itemized deductions," or

in some years “a zero bracket amount or nonbusiness deduction.” These deductions were included in Idaho taxable income in proportion to “a” over “b.”<sup>3</sup> For taxable years 1983 through 1999, Idaho law relied upon federal law in determining what constituted “itemized deductions.” Idaho Code section 63-3002 (1983 through 1998). Therefore, during the years at-issue, to the extent that a particular deduction was considered an “itemized deduction,” that item was only includible in the calculation of a nonresident’s Idaho taxable income to the extent that it included the specific proration calculation contained in the Idaho statute.

In their petition for redetermination dated April 12, 2001, the petitioners state, “It seems inconsistent to treat the interest income as business income and the interest expense as a non-business deduction simply because it flows through as investment interest on the shareholder’s Schedule A, due to the passive loss rules created by the 1986 Tax Reform. For all of the years at-issue.” Even before the passage of the Tax Reform Act of 1986, Internal Revenue Code section 63 treated the investment interest deduction found in Internal Revenue Code section 163 as an itemized deduction. Therefore, under Idaho law, investment interest expense or a portion thereof, is only included in the calculation of a nonresident’s Idaho taxable income to the extent it is included in accordance with the specific proration calculation contained in the Idaho statute.

#### Idaho Net Operating Loss and Investment Interest Expense

To what extent an “itemized deduction” or “nonbusiness deduction” is included in the calculation of the Idaho net operating loss is governed by Idaho Code section 63-3021.

For tax years 1983 through 1988, Idaho Code section 63-3021 stated:

63-3021. NET OPERATING LOSS. The term “net operating loss” means “net operating loss” as defined in section 172(c) of the Internal Revenue Code, except that the modifications referred to in said section shall be limited to those specified in paragraphs 1, 2, 3 and 4 of section 172(d), provided further that the adjustments

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<sup>3</sup> For most of the years involved, “a” represented Idaho Adjusted Gross Income while “b” represented Total Adjusted Gross Income.

required by section 63-3022 shall be directly reflected in and enter into the determination of such net operating loss.

In looking at ITA's calculation of the petitioners' Idaho net operating loss for tax years 1987 and 1988, investment interest expense (\$25,727 and \$5,234,262 for tax years 1987 and 1988, respectively), reported on Schedule A of the petitioners' federal return as an itemized deduction, was taken into consideration in determining their Idaho net operating loss as follows:

	1987	1988
Idaho Adjusted Gross Income	(\$1,257,499)	\$125,257
Federal Nonbusiness Deductions (Idaho portion) (Total itemized deduction (\$32,832) less \$605 of state income taxes times Idaho proration percentage of 26%)	(\$8,379)	
Federal Nonbusiness Deductions (Idaho portion) (Total itemized deduction (\$5,275,696) less \$1,754 of state income taxes times Idaho proration percentage of 100%; limited to nonbusiness income of \$346,411)		(\$346,411)
Idaho Net Operating Loss	(\$1,265,878)	(\$221,154)

"Nonbusiness" expenses enter into the calculation of the Idaho net operating loss for these two years due to the Idaho statute's reference to Internal Revenue Code section 172(d)(4). Internal Revenue Code section 172(d)(4) stated "in the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business." Therefore, part of the petitioners' investment interest expense was factored into the calculation of the Idaho net operating loss. The amount of nonbusiness deductions, which includes the investment interest expense, was limited to \$346,411, the amount of nonbusiness income from Idaho sources.

Another reason that the petitioners' 1987 and 1988 Idaho net operating losses were substantially reduced was a result of ITA's recalculation of the petitioners' Idaho source income

for these years. ITA determined that the petitioners' underreported their Idaho source income by \$663,035 and \$1,203,166 for taxable years 1987 and 1988, respectively.<sup>4</sup> The increase in the petitioners' Idaho source income substantially reduced or eliminated in its entirety the Idaho net operating loss for that year.

In 1989, Idaho Code section 63-3021 was repealed and replaced with the following language:<sup>5</sup>

**63-3021. NET OPERATING LOSS.** (a) The term "net operating loss" means taxable income as defined in section 63-3022, Idaho Code, with modifications as specified in subsection (b) of this section.

(b) Modifications:

(1) The amount of any net operating loss deduction included in taxable income shall be added back to taxable income.

(2) In the case of a taxpayer other than a corporation:

(i) Any amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includable on account of gains from sales or exchanges of capital assets; and

(ii) Any deduction for long-term capital gains provided by this chapter shall be added to taxable income.

(3) Any deduction allowed under section 151 of the Internal Revenue Code (relating to personal exemption) or any deduction in lieu of any such deduction shall be added back to taxable income.

(4) Any deduction for the standard or itemized deductions provided for in sections 63(c) and (d) of the Internal Revenue Code, except for any deduction allowable under section 165(c)(3) of the Internal Revenue Code (relating to casualty losses) shall be added back to taxable income. Casualty losses for property physically located in Idaho at the time of the casualty may be deducted from Idaho taxable income.

The impact that this change has on the petitioners' calculation of their Idaho net operating loss for taxable years 1989 through 1998 is the elimination of itemized deductions (except for certain casualty losses) from the calculation of an Idaho net operating loss. The petitioners seek to include investment interest expense (or a portion thereof) from 1989 through 1998 in the

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<sup>4</sup> See Exhibit 1 at the end of this decision for the increase or decrease in Idaho source income per ITA.

<sup>5</sup> H.B. No. 46, Idaho S.L. 1989, Ch. 27.

calculation of their Idaho net operating loss carryover, which the Idaho statute clearly does not allow.

### Conclusion

ITA made several adjustments to the petitioners' Idaho net operating loss carryforward that were unrelated to the Idaho source income or investment interest expense issues discussed in this decision. The petitioners did not protest these adjustments.

As pointed out previously in this decision, to the extent that the investment interest expense was considered an itemized deduction in taxable years prior to 1989, the investment interest expense or a portion thereof was taken into consideration by ITA in determining the petitioners' Idaho net operating loss. For tax years 1989 through 1998, ITA correctly excluded the investment interest expense from the calculation of the petitioners' Idaho net operating loss.

The U.S. Supreme Court has stated:

Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed. . . . Obviously, therefore, a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms.<sup>6</sup>

It is clear from the change in the language of Idaho Code section 63-3021 in 1989 that itemized deductions were no longer included in the calculation of an Idaho net operating loss. Therefore, to include investment interest expense in the calculation of an Idaho net operating loss for tax years 1989 through 1998, in the manner suggested by the petitioners, would be in violation of Idaho law. Furthermore, a Notice of Deficiency Determination issued by the Idaho State Tax Commission is presumed to be accurate. Parsons v. Idaho State Tax Com'n, 110 Idaho

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<sup>6</sup> New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934); *see also* Appeal of Sunny Ridge Manor, Inc., 106 Idaho 98, 675 P.2d 813 (1984); Bistline v. Bassett, 47 Idaho 66, 272 P. 696 (1928).



572 (Ct. App. 1986). The petitioners' have not shown that the Notice of Deficiency Determination is in error or that they are entitled to the deduction they seek.

WHEREFORE, the Notice of Deficiency Determination dated February 12, 2001, is hereby APPROVED, AFFIRMED, and MADE FINAL.

An explanation of the petitioners' rights to appeal this decision is enclosed with this decision.

DATED this \_\_\_\_ day of \_\_\_\_\_, 2002.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

### **CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_ day of \_\_\_\_\_, 2002, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[REDACTED]  
[REDACTED]

Receipt No. [Redacted]

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ADMINISTRATIVE ASSISTANT 1